

Office of Chief Counsel
Internal Revenue Service
memorandum

CC:NER:NJD:TL-N-416-99
PYTaylor

date: **APR 20 1999**

to: Chief, Examination Division, Manhattan District

from: District Counsel, New Jersey District, Newark

subject: [REDACTED] - [REDACTED]
U.I.L. No. 7805.04-01

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This memorandum has been prepared in response to your request for advice on the above-mentioned taxpayer.

Issues

1. Rev. Proc. 94-12, 1994-1 C.B. 565 prohibits corporations, with an effective election under section 936 of the Internal Revenue Code, from obtaining automatic approval of a change in annual accounting period under Rev. Proc. 92-13, 1992-1 C.B. 665. The issue is whether the Commissioner abused his discretion in issuing Rev. Proc. 94-12, 1994-1 C.B. 565, on a retroactive basis.

2. Whether the change of accounting period issue should be designated for litigation, pursuant to Internal Revenue Service manual section (35)3(14)?

Facts

[REDACTED] (hereinafter [REDACTED]) is a U.S. subsidiary of [REDACTED]. [REDACTED] manufactures pharmaceuticals in [REDACTED]. [REDACTED] was incorporated in [REDACTED] and has continuously elected to be a section 936 corporation. For all years prior to and including December 31, [REDACTED], [REDACTED] filed calendar year tax returns. On [REDACTED], [REDACTED] filed Form 1128 to request a change of tax year to October 31, [REDACTED]. [REDACTED] indicated that its Form 1128 was filed in accordance with Rev. Proc. 92-13.

Discussion

Section 936 was enacted as part of an initiative to stimulate the economies of U.S. possessions. It provides electing corporations with a tax credit equal to the U.S. tax which would be imposed on taxable income from sources without the U.S. with respect to the active conduct of a trade or business in a possession or the sale or exchange of substantially all the assets used in that trade or business and qualified possession source investment income. Congress has amended section 936 several times since enactment. On August 10, 1993, section 936(a)(4), enacted under OBRA, was signed into law. Section 936(a)(4) reduced the tax credit available to corporations electing 936 treatment for tax years beginning after December 31, 1993. The benefit was reduced on a gradual basis beginning in 1994 to 60 percent of the prior benefit, 55 percent in 1995, 45 percent in 1997 and 40 percent in 1998 and thereafter.

Around the time of enactment of section 936(a)(4), many corporations sought to delay the effective date of the statute through either a change in the accounting period or a reorganization. Many corporations filed Form 1128, Application to Adopt, Change or Retain a Tax Year, under the provisions of Internal Revenue Code section 442 and Rev. Proc. 92-13. Section 442 provides that a change in a taxpayer's annual accounting period must be approved by the Commissioner to be effective. Treas. Reg. 1.442-1 and several revenue procedures permit changes to an annual accounting period without the Commissioner's consent. Under Rev. Proc. 92-13, certain corporations may obtain expeditious approval of a change in accounting period if certain conditions are met. Section 4 of the revenue procedure excludes

certain corporations from utilizing the automatic approval procedures. Section 936 corporations are not included in that list. To prevent section 936 corporations from utilizing the automatic approval provisions of Rev. Proc. 92-13, the Service issued Rev. Proc. 94-12. Rev. Proc. 94-12, which was retroactive to August 10, 1993, modified section 4 of Rev. Proc. 92-13 to add section 936 corporations to the list of corporations excluded from utilizing the automatic approval procedures.

Retroactivity of Rev. Proc. 94-12

I.R.C. section 7805 provides that regulations and rulings are retroactive, unless the Commissioner exercises his discretion to make it prospective only. Dixon v. United States, 381 U.S. 68 (1965). Such rules and regulations are presumptively retroactive to the date of enactment of the statute to which they relate unless the Commissioner prescribes otherwise. Treas. Reg. 301.7805-1(b). The decision to retroactively apply a regulation or ruling is subject to judicial review under an abuse of discretion standard. Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957). An abuse of discretion can be inferred where 1) retroactivity would change settled law relied upon by taxpayers and implicitly approved by Congress; 2) application of the ruling leads to inequality or disparate treatment of similar taxpayers; and 3) the results of retroactivity would be unduly harsh on taxpayers. Norfolk Southern Corporation v. Commissioner, 140 F3d 240 (1998); Mulholland v. United States, 16 ClsCt 252 (1989).

A revenue procedure is a statement of procedure that affects the rights or duties of taxpayers or other members of the public under the Code and related statutes or information that, although not necessarily affecting the rights and duties of the public, should be a matter of public knowledge. Reg. 601.601(d)(2). The question of whether revenue procedures are treated in the same manner as revenue rulings was the issue in Matson Navigation Company v. Commissioner, 68 T.C. 847 (1977).

In Matson, the taxpayer sought to prevent the retroactive application of Rev. Proc. 68-27, 1968-2 C.B. 911, involving the computation of depreciation deductions. Rev. Proc. 68-27, which did not have a specific effective date, was issued to prescribe the procedures applicable to Rev. Proc. 62-21, 1962-2 C. C. 418, in cases where there had been changes to certain assets with a short class life. The Commissioner argued that Rev. Proc. 68-27 was a restatement and clarification of the earlier Rev. Proc. and of regulation 1.167(b).

The Tax Court found that the Commissioner traditionally treated revenue procedures and revenue rulings differently. In Rev. Proc. 55-1, 1955-2 C.B. 897, the IRS announced a policy of publishing as revenue procedures all statements of practice and procedure but this new policy did not apply to "interpretations of substantive tax law publishable as revenue rulings." Revenue rulings and revenue procedures are published in the Internal Revenue Bulletins. The introduction to the Bulletin provided that "except where otherwise indicated, published rulings and procedures apply retroactively." Then, in 1967, the introduction to the Internal Revenue Bulletin was amended to provide:

It is the policy of the Service to publish in the Bulletin all *substantive* rulings necessary to promote a uniform application of tax laws *All published rulings apply retroactively unless otherwise indicated.* Procedures relating solely to matters of internal management are not published; however, industry regulations appearing in internal management documents and statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

The Court also found that the Commissioner distinguished revenue rulings and revenue procedures in several revenue procedures. See Rev. Proc. 68-44, 1968-2 C.B. 954; Rev. Proc. 72-1, 1972-1 C.B. 693.

The Court held that since the Commissioner distinguished revenue procedures from revenue rulings and Rev. Proc. 68-27 did not have an effective date, the revenue procedure was intended to be applied prospectively only. The Court stated that to apply this revenue procedure retroactively would be contrary to the IRS policy of not making rulings apply retroactively when it would adversely affect taxpayers who had relied upon the earlier rulings.

The issue in this case can be distinguished from the principles of Matson. First, Rev. Proc. 94-12 specifically provides that it is effective retroactively to August 10, 1993. Since the revenue procedure contains a specific effective date, the Commissioner exercised his authority provided by section 7805. Second, Rev. Proc. 94-12 was issued to prevent taxpayers from circumventing the effects of recently enacted section 936(a)(4). Its effective date coincided with the effective date of the pertinent statute.

Third, multinational corporations were aware of the Congressional hearings and proposed legislation reducing the

benefits of the tax credit. During the summer of 1992, Congress discussed reducing the 936 credit. These proposals faced strong opposition from [REDACTED] and large multinational corporations doing business in [REDACTED]. In November, 1992 President Clinton proposed a major revision to the credit. On February 16, 1993, legislation was introduced into the Congress proposing a phase out of section 936 over five years and simultaneously introducing a wage based credit, effective January 1, 1993. After much discussion and lobbying by multinational corporations, a revised version of the President's proposal was passed in August, 1993 as part of OBRA. (Eden, Lorraine. "Puerto Rican Transfers and Section 936" Tax Notes International (July 4, 1994)).

Designation for Litigation

In some circumstances the Service has deemed it appropriate to designate an issue in a case for litigation rather than settlement. Designation of an issue for litigation prevents settlement of the issue without a full concession by the taxpayer. Issues have been designated in order to 1) resolve recurring significant issues, 2) establish judicial precedent, 3) conserve resources, or 4) reduce litigation costs for the Service and taxpayers. IRM (35)3(14)2.

The office recommending designation must demonstrate why litigation is the most desirable method of resolving the issue, establish the goal of the litigation, analyze the impact of both a favorable and an unfavorable opinion and ensure that other methods of resolving the issue, such as a regulation, ruling revenue procedure or legislation, have been considered.

(b)(5)(AC), (b)(7)e

(b)(5)(AC), (b)(7)e

Conclusion

This office recommends that the agents pursue development of the change of accounting period issue under standard examination procedures.

Direct all inquiries in this matter to the attention of Patricia Taylor, (973) 645-6196.

MATTHEW MAGNONE
District Counsel

By: /s/ Patrick E. Whelan
PATRICK E. WHELAN
Assistant District Counsel

NOTED:

MATTHEW MAGNONE
District Counsel

cc: Anthony Inzerillo